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Money and Banking

Money:

Meaning and Function

BARTER SYSTEM

MEANING

Barter system means the direct exchange of one commodity for another.

DIFFICULTIES OF BARTER SYSTEM

1. Lack of Double Coincidences: - Barter system can only work when to both the persons are ready each other's goods.

2. Lack of Divisibility: - There are many goods which are not divisible. Hence, exchange becomes impossible.

3. Lack of Common measure: - Different commodities are of different values. In this situation, it is difficult to decide in what proportion are the two goods to be exchanged.

4. Difficulty in Deferred payment: - It is very difficult to make a deferred payment in the form of goods.

<u>5. Difficulty in Exchange of services</u>: - The exchange of services would far more difficult than the exchange of goods.

MEANING OF MONEY

The definition of Crowther is more reliable. He defines Money is anything that is generally acceptable as a means of exchange at the same time, acts as a measure and as a store of value.

FUNCTION OF MONEY

In modern times, money perform are a number of functions. These function are broadly classified into three categories:

1. Primary Function of Money

Primary Function of money include the most important function of money. There are two primary function of money.

a) Medium of Exchange: - It is a very important function of money. Any commodity can be purchased or sold through the medium of money.

b) Measure of value (or unit of value): - Value of all goods and services are expressed in terms of money. Thus, when the value of all the commodities is expressed in terms of money, it becomes easier for anyone to compare the relative values of any of the two commodities.

2. Secondary Functions of Money

Money also performs following three secondary functions:

a) Standard of Deferred payment: - Money serves as the measure by which the value of future payment is regulated. In modern economic system, loans are generally given and taken and the repayment is generally postponed for a future date. Money is therefore used as a standard of deferred payment.

b) Store of Value: - Though wealth can be stored in the form of physical goods, people like to hoard it in the form of money. It enables people to save a part of their current income and store it for future use.

C) Transfer of value: - Money helps us to transfer values from one person to another and from one place to another. Money is readily acceptable by all and in all the places.

3. Contingent Functions

Contingent Functions refer to the incidental functions of money. Main contingent Functions are production

a) Distribution of National Income: - Money helps to distribute the national income among various factor of production in the form of wages, interest, rents and profits.

b) Maximum Satisfaction to the consumer: - A consumer who aim at maximum satisfaction buy goods and services in such a way that price of each commodity is equal to its marginal utility.

c) Liquidity: - Money is the most liquid of all the asset. Money can be easily converted into any goods and assets. It is because of liquidity that people desire to have money.

SUPPLY OF MONEY

The supply of money refers to the amount of money held by the Public in an economy at any given time. The money held by the Government and currency lying with the central bank and commercial bank is not included in money supply in order to avoid double counting.

CONSTITUTE OF MONEY SUPPLY

There are two approaches regarding the constituent of money supply:

(i) Traditional approaches and

(ii) Modern or broader approach.

1.Traditional or Narrow Approach

According to narrow approach , all these assets which perform the function of medium of exchange are included in the supply of money .

a) Currency Money: Currency money is also termed as legal tender money. Because it is recognised and issued by has full legal sanction. It is of two types a) coin and b) Paper currency and notes. Coin used to be the principal type of money in circulation in the past, but now currency note are most important part of the money supply. In India, RBI have the monopoly with regard to the issue of currency notes leaving one - rupee notes. One- rupee notes are issued by Ministry of Finance of Government of India.

b) Demand Deposits by Commercial bank: Demand deposits are termed as bank money. Bank Demand deposits are also referred to as

money supply because they are transferable by cheques in settlement of debts.

Supply of money (M) = Coins + currency notes + Demand deposits

(ii) Modern or Broader Approach

According to modern approach, money supply includes: (i) Coin (ii) Currency (iii) Banks demand deposits (iv) Time deposits with bank (v) Financial assets such as deposits with non- banking financial institutions like the unit trust, building societies, post office saving banks etc. (vi) Bills - Treasury and Exchange bills (vii) Bonds and equities (viii) Credit Cards .

RESERVE BANK OF INDIA'S APPROACH OF MONEY SUPPLY

The Reserve bank provides measures of money supply in the Country in accordance with both narrow as well as broader approach. For this purpose, RBI has adopted four measures of money supply.

M_1 Consist of

(i) Currency notes and coins worth the public (excluding cash - in - hand for all Commercial bank.
(ii) Demand deposits
(iii) other deposits held with the RBI.

M_2 Consist of

(i) M_1 and
(ii) Saving deposits with post office saving bank.

M_3 consist of

(i) M_1 and
(ii) Time deposits of all commercial and co - operative bank.

M_4 Consist of

(i) M_3
(ii) Total deposits with the post office saving Organisation.

M_4 is a broader concept than M_3. On the other hand M_1, and M_2 are measures of narrow approach of money supply. The RBI provides estimates of the supply of money in terms of all four concepts of money supply. They indicate varying degrees of the Liquidity. M_1 represents the highest and M_2 and M_3 and M_4 follow it is descending degree of liquidity order in terms of liquidity.

FACTOR AFFECTING MONEY SUPPLY

1 Monetary policy of the Central bank: - If the central government follows a dearer monetary policy (i.e. increase in bank rate and Cash reserve ratio and purchase of securities in the open market etc.) the money supply will be reduced and vice versa.

2. Commercial banks Capacity and policy of credit creation: The capacity of the bank to expand the volume of bank deposit depend upon the cash available to the banking system. The larger the cash balance the more will be the volume of deposit expansion and vice versa.

3. Government fiscal policy: when the government follows a deficit budget policy, the money supply increases. On the other hand, when government follows a surplus budget policy the money Supply

decreases.

4. Community choice: The credit creating capacity of the commercial bank is also influenced by the public desire to hold cash. If the public desires to hold more cash than the credit creation is lesser and vice versa. Banking habit of the public also affects money supply in the economy.

Commercial banks

BANKING

Banking public and lending can be defined as accepting money deposits from the public or making investments.

MEANING AND DEFINITION OF A COMMERCIAL BANK

According to Banking Regulation Act 1949, "Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and with draw able by cheque, draft, order or other.

FUNCTION OF COMMERCIAL BANKS

There are two main functions of commercial banks in a country: Acceptance of deposits from the public and lending.

1. Acceptance of deposits from the public

An important function of commercial bank is to accept deposits from the public. Banks accepts deposits from the Individuals, business firms and other institutions. These deposits are mainly of three types: Demand deposits, Savings deposits and fixed deposits)

a) Demand deposits (Current a / c deposits):- Deposits in the current a/c are known as demand deposits. Because these deposits are repayable on demand, they are termed as demand deposits. The depositor can deposits or withdraw money as and when they like. The bank does not pay any interest on demand deposits, but, make small charges on the Customers with current a/c.

b) Savings deposits: - Saving deposits are those deposits on which the bank pay a certain percentage of interest to the depositors but place certain restrictions on their withdrawal. Thus, saving deposits have the feature of both current a/c deposits as well as fixed a/c deposits.

C) Fixed deposits: - In fixed deposits account money is kept for a specified period. These deposits are also known as term deposits or time deposits. Money deposited in the fixed deposits cannot be

withdrawn before the expiry of the period for which it was contracted. The higher rate of interest is paid on such deposits.

A new type of fixed deposits are recurring deposits. Under this account, a specified amount is deposited every month for specified period.

2. Advancing of Loans

The Second major function of a commercial bank is to give loan and pay advances out of their deposits. The commercial bank gives advance through variety of way.

a) Cash credit: - Under this system, a borrower is sanctioned a credit limit up to which he may borrow from the bank. This Credit limit is determined on the basis of the borrower's Credit worthiness. The borrower has to pay interest on the 'drawn' or 'utilised' portion of the credit limit only.

b) Money at call or demand loan: - These types of loans can be withdrawn (recalled) on demand. It has no fixed maturity period. Interest is charged on the entire amount of loan sanctioned. This type of loans are generally taken by the security broker and other whose credit needs keep fluctuating day - by - day.

C) Short term Loans: - These loans may be given as personal loan to finance working capital or as priority sector advances. Short term loans are made against some security. The repayment is made either in one instalment at the end of the loan period or in number of

instalments over the period of time.

d) Other facilities: - Bank also extend the following facilities to their Customers.

i) Overdrafts: - An overdraft is an advance given by allowing a Customer to overdraw his current a/c up to an agreed limit.

ii) Discounting of bills of exchanges: - Under this methods, banks give advances to their clients on the basis of their bills of exchange before the maturity of such bills. A deduction is made out of the face value of the bill for the period the bill is yet to run. This deduction is known as discounting of the bill. On the expiry of maturity period, the amount mentioned in the bill is collected from the party concerned by the bank.

3. Investment of funds

The banks invest their surplus funds in two types of securities:

(i) Government Securities - These are of both the central government and state government such as treasury bills, national saving certificate etc.

(ii) Other approved securities are securities under the provision of banking Regulation Act 1949.

4. Agency Functions

Bank also act as financial agents of their customers. These services included the following:

(i) Remittance of funds: - Bank remit funds, on behalf of their clients, by mail transfers or demand drafts.

(ii) Collection and payment of funds: - Bank also collect and pay the cheques, bills, promissory notes, dividend warrants, rent, income tax, insurance premium and other receipts and payment on behalf of their clients.

(iii) Sale and purchase of Securities - Bank also sell and purchase shares, stocks, debentures, bonds etc. on behalf of their customers.

(iv) Trusteeship: - Commercial banks also act as executors, trustees and attorneys for their customers. Sometimes, banks also appoint income tax expert to prepare and finalise the income tax returns of their Clients. Bank also help their customers to get refund of income tax.

5. General utility Function

Modern Commercial banks also perform general utility services. Under this service, following function were included:

(i) Receiving the valuables, ornaments, jewels, document and dead for their customers for keeping in lockers.

(ii) Bank Collect informations about trade, industry and finance and also advise customers on financial matters.

(iii) Issuing a bank drafts and traveller's cheques in order to facilitate the transfer of funds from one part of the Country to the other.

FACTOR AFFECTING CREDIT CREATION

The credit creation capacity of banks depends mainly on the following factor:

1. Primary cash deposits: - The larger the availability of cash, the larger will be the quantum of cash credit creation.

2 Cash Reserve Ratio: - The higher the cash reserve ratio, the lower the Credit Creation capacity.

3. Banking Habit and of the people: - In the countries where people prefer to deal through banks, credit creation will be more and vice versa.

4. Policy of the central bank: - If its policy is to encourage credit creation, it will adopt cheap money policy. On the contrary, if its policy is to discourage credit creation, it will adopts dear credit policy.

The Central BANK

In every country, there is one apex institution which acts as the leader of the money market. It supervises, regulates and controls the activities in the commercial banks and other financial institutions. Such institution is called the central banks of the country. In India, Reserve bank of India is the central bank of the country.

DEFINITION OF A CENTRAL BANK

In Simple words, "A central bank is an apex institution which operates, Controls directs and regulates the monetary and banking structure of a country.

COMPARISON BETWEEN A CENTRAL BANK AND A COMMERCIAL BANK

1. The Central bank is the apex institution of the entire monetary and banking structure of the country. On the other hand, a commercial bank is merely a unit or a part of the banking structure of the country.

2. Every country only one central bank, while a country has several commercial bank.

3. A commercial bank is operated for profits but the central bank is set up basically for public interest rather than for profit.

4. A central bank does not directly deal with the public. On the other hand, a commercial bank deals directly with the public.

5. The central bank enjoy monopoly power to issue currency, while the commercial bank are not authorised to undertake this function.

6. The Central bank Controls credit, while commercial bank creates Credit.

FUNCTION OF CENTRAL BANK (RBI)

In our country, RBI is the central bank of the country. Hence it Perform all the functions of a central bank.

1. Bank of issue (or currency Function): RBI in our country has been given a sole right of issue of currency notes (except one rupee notes which is issued by Ministry of Finance).

2. Banker, Agent and Advisor to the Government: As a banker to the Government, "the central bank make and receives payment on behalf of the Government (Central as well as state Government).

As government agent, the central bank conducts sales and purchase of government securities and also manages the national debt as well as foreign debts.

The Central bank also acts an advisor to the government, especially on monetary, banking and financial matters.

3. Custodian of the cash Reserves of Commercial banks: - All Commercial banks keep part of their cash deposits with the central bank of the country.

4. Custodian of National Reserves of International currency: The Central bank is the custodian of the country's stock of gold and international currency. All receipts and payment in foreign exchange are made by the central bank. Through this function the central bank maintain rate of exchange and manage exchange control.

5. Lender of the last Resort: - the central bank lends to the commercial bank in times of unanticipated emergencies. A

Commercial bank can borrow from the central bank against eligible securities.

6. Controller of Money Supply and Credit: - Through this function, the central bank attempts to influence and control the volume of bank Credit and economic activity in the Country. Central bank can control inflationary and deflationary situations in the economy through various credit control measures.

7. Bank of Central clearance: - Because central bank keeps the cash balances of all Commercial banks, it is easier for member's banks to adjust their claim against each other in the books of the central bank.

INSTRUMENT OF MONETARY POLICY OR CREDIT CONTROL MEASURES

Credit control measures can broadly be classified into 2 categories

1. Quantitative credit control measures

Quantitative credit control measures are the measures which are supposed to control the total volume of bank credit. The main quantitative control measures are as follows:

i) Bank rate Policy

The rate at which central banks advances loans to the commercial bank is known as bank rate or discount rate.

An increase in bank rate by RBI will raise the cost of borrowing by the Commercial bank and consequently, they also increase their lending rates. This will leads to contraction of credit.

A decrease in bank rate by RBI lowers the interest rate and the business Community borrows more. This lead to expansion of credit.

(ii) Open market operations

Open market operations refers to the policy of sale and purchase of securities in the open market by the RBI, when RBI starts selling the securities in the market, this reduces the cash reserves of the commercial banks, which in turn, reduces the credit creating capacity of these banks.

On the other hand, when RBI purchases the securities in the open market, it raises the reserve fund of commercial banks which, in turn, increases the credit creation capacity of these banks. Thus, credit expands with the purchase of securities and contracts with their sales.

(iii) Variable Reserve Requirement

Commercial banks are required to maintain two types of reserves with the central bank

(a) Cash Reserve Ratio: Every commercial bank is required to keep a minimum percentage of its total deposits with the central bank. This is termed as cash reserve ratio (CRR). An increase in CRR reduces the cash reduces the credit reserves of the commercial banks which, in turn, reduces creation capacity of the banks.

(b) Statutory liquidity ratio: - The Commercial bank are also required to maintain a minimum amount of their total liabilities in the form of liquid asset. This is termed as SLR. Increase in SLR reduces credit creation Capacity and decrease in SLR increases the credit creation Capacity of banks.

2. Qualitative Credit Control Measures

The credit control measures which contain certain type of credit and allocate Credit between alternative uses are called qualitative or Selected Credit Control measures.

(i) Change in Marginal Requirement: - The difference between the value of the security and the amount of loan is known as marginal requirement. By varying margin requirement the central bank can expand Or Contract creating capacity.

(ii) Control of Consumer Credit: - The Central bank can make, costlier or easier the loans given by the commercial banks to purchase durable consumer goods.

(iii) Moral Suasion: - Moral Suasion implies persuasion, request, informal suggestion, advice and appeal by the central bank to the commercial banks to Co-operate with the general monetary policy.

(iv) Selective Credit Control (SCCs): In this method the central bank can give direction to the commercial banks not to give credit for

certain purposes or to give more credit for particular purposes or to the priority sector.